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Agricultural Situation

European Union Rural Development Policy: Overview of Modulation

2007

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Report Highlights:
The following report gives a brief overview of how the European Union concept of Modulation works. As a result of the 2003 CAP Reform the European Union mandates Compulsory Modulation of 5 percent of Direct Payments for 2007. In addition to Compulsory Modulation the EU recently granted individual Member States the ability to voluntarily modulate additional Direct Aid spending. Compulsorily Modulated funds are spent on Rural Development programs with additional co-financing coming from individual Member States. Voluntary modulation does not require co-financing. Recently, EU Agriculture Commissioner Fischer Boel has signaled the desire to increase the compulsory rate past the current 5 percent limit However, the European Commission has stated that this will not occur before 2013.

Includes PSD Changes: No
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Introduction

Modulation is the Common Agricultural Policy (CAP) principle whereby funds from Pillar 1 (direct aids to farmers) are transferred to Pillar 2 (rural development activities). Currently, the European Commission imposes a mandatory 5 percent Modulation on EU member states meaning 5 percent of Direct Payments spending is transferred to Member States' Rural Development budgets. Recently European Union Agriculture Commissioner Mariann Fischer Boel has publicly laid the groundwork to increase compulsory modulation beyond the current 5 percent mandate. However, the European Commission has stated that if this were to happen it would be after 2013.

In March 2007 the EU implemented EC Regulation Number 378/2007 giving EU Member States the ability to increase the amount transferred from Pillar 1 to Pillar 2, capping the amount at 20 percent of Pillar 1 spending through Voluntary Modulation (see GAIN 47026).

European Council Regulation Number 1782/2003 outlines the legal authority to mandate compulsory modulation by Member States. In the European Union budget, modulated funds remain in the Direct Aid title and are given to Member States who then spend the funds on Rural Development programs. The EU budget does not track the transfer of funds from one title to the other. Additionally, Modulation only occurs and is only dispersed to the Member States that comprised the European Union – 15. It has yet to be extended to New Member States.

Until the end of 2006, Member States used the funds to bolster budgets for development measures funded by the 'Guarantee Section' of the agriculture budget. The Guarantee Section includes Chapter 4 of Title 5, the Agriculture and Rural Development title of the European Union General Budget. In January 2007, the Rural Development portion of the 'Guarantee Section' of the budget was renamed the European Agricultural Fund for Rural Development and is still located in Chapter 4 of Title 5. Appendix A outlines the three major agriculture titles in Chapter 4 of the EU budget that makes up the majority of the Common Agricultural Policy.

Historical Background

The Agenda 2000 reform first introduced modulation, however under that reform modulation was voluntary and was not adopted by Member States on a wide basis. The 2003 CAP Reform reintroduced modulation, now making it a compulsory action, and pegging the amount of modulation at a percentage of Direct Payments. Two key factors prompted the European Commission to make this change: financial discipline concerns regarding the overall CAP budget and overall support among EU citizens to promote Rural Development programs.

To address the financial discipline the Commission continued to strictly enforce budgetary ceilings on CAP subheading 1a expenditures, known as Pillar 1. However, the reform imposed no ceiling on expenditures on Rural Development measures, known as Pillar 2.

Modulation addresses the concern of increasing support for Rural Development within the EU by mandating that a percentage of Single Farm Payment (direct payments) spending be transferred to the Rural Development budget. For 2005, 3 percent of the direct payment budget was transferred to Pillar 2 with the rate increasing to 4 percent in 2006 and finally to 5 percent in 2007. Currently, 5 percent is the rate set for the period between 2007 and 2013.

In March 2007 the European Union implemented a new Voluntary Modulation proposal that allows Member States to divert up to 20 percent of the Single Farm Payment budget to the Rural Development budget if the Member State meets one of two conditions: 1) the Member State already applies a voluntary modulation system (UK only) or 2) the member state already has an exemption from co-financing rural development measures (Portugal only). Given the controversy over voluntary modulation which erupted in the European Parliament in February 2007 one can anticipate that no other Member State will set up a voluntary modulation system in the near future.

How Modulation Works

Modulation, in theory is a simple concept: the transfer of budgeted spending from one category of spending to another. However, like many European Union budgetary mechanisms a complex system governs how money is raised and how money is disbursed.

Determining the amount 'modulated' is relatively easy. The compulsory rate of 5 percent (using 2007 as an example) is taken from the total Single Farm Payment budget allocated to the specific country, save for up to the first 5,000 euro payment guaranteed for every farmer. This amount is then totaled across the entire European Union and transferred to rural development programs. Modulation transferred 1.165 billion euros from the Single Farm Payment scheme to the Rural Development Program under the 5 percent Modulation rate.

Determining how the money is then allocated among Member States becomes more complex as contributions and payouts are not on a 1 for 1 basis. The first step requires determining the Allocation Key, which is then used to determine how much funding Member States receive. The 'Allocation Key' is determined by a complex equation which takes into account a Member State's relative agricultural area (weighted 65%), relative agricultural employment (weight 35%), and then adjusts it to the Member States relative GDP/capita. Appendix B at the end of this report outlines how the Allocation Key is determined for each Member State and how each State falls under the calculation.

The Allocation Key is the first step in the process to determining the financing of a Member State's Rural Development budget by Modulation. A base 1 percent of the total compulsory modulation rate (20 percent in the case of 5 percent compulsory modulation for 2007) is automatically retained by the Member State. Secondly, the Allocation Key is used to distribute the remaining funds. Finally, there is a caveat applied that allows Member States to retain at least 80 percent of the modulation finance in the form of development finance. This principle is known as the 80 percent / 90 percent minima condition. Member States that would receive below 80 percent of what they contributed (90 percent in the case of Germany) receive an additional topping up of the fund to 80 percent of what they contributed (90 percent in the case of Germany). The following table outlines the breakdown of Modulation distributed by Member State.

The column titled Modulation is the amount contributed by each Member State to the Modulation budget. The column titled Total is the amount a Member State receives in Modulation.

European Union Modulation Payment/Distribution Table (million euros)							
Member State	Modulation	20% Direct	Allocation Key	Additional Direct	Total	Loss/Gain	% return
Belgium	18.8	3.8	8.8	2.5	15.1	-3.7	80.0
Denmark	37.8	7.6	14.0	8.7	30.3	-7.5	80.0
Germany	211.1	42.2	107.8	40	190.0	-21.1	90.0
Greece	29.5	5.9	45.2	0	51.1	21.6	173.4
Spain	140.1	28.0	160.0	0	188.0	47.9	134.2
France	325	65.0	159.3	35.7	260.0	-65.0	80.0
Ireland	40.4	8.1	22.4	1.9	32.4	-8.0	80.0
Italy	100.7	20.1	99.6	0	119.7	19.0	118.9
Luxembourg	1.4	0.3	0.5	0.4	1.2	-0.2	80.0
Netherlands	29.2	5.8	19.1	0	24.9	-4.3	85.3
Austria	14.7	2.9	34.2	0	37.1	22.4	252.6
Portugal	11.8	2.4	41.9	0	44.3	32.5	374.7
Finland	14.3	2.9	14.6	0	17.5	3.2	122.1
Sweden	25.9	5.2	17.2	0	22.4	-3.5	86.5
United Kingdom	165.1	33.0	81.8	17.3	132.1	-33.0	80.0
EU-15 Total	1165.8				1165.8		

In the case of France an additional amount must be allocated to satisfy the minima condition. Currently, Belgium, Denmark, Germany, France, Ireland, Luxembourg, and the United Kingdom require additional transfers to satisfy the minima condition.

How is Modulation Spent

Member State treasuries must match all compulsory modulated funds. Any additional voluntary modulation does not have to be matched by Member State treasuries. Currently, there is no European Commission regulation restricting how modulation funds can be spent by Member States but the Commission mandates compulsory minimum and possible maximum budget allocations to the three rural development axes.

Rural Development programs are broken down into four areas or axes as defined by the European Commission. Modulation funding can fund programs under the first three axes:

1. improving competitiveness of farming and forestry
2. environmental stewardship in land management
3. improving the quality of life in rural areas

Countries must allocate EU Rural Development spending in programs under the three axes. Some Rural Development programs that receive modulation finance are the early retirement scheme, assistance to farmers in less favored areas (marginal yield areas), and environmental programs. Spending of compulsory modulated funds must be appropriated and co-financed by individual Member States according to these guidelines:

	EAFRD budget allocations		EAFRD co-financing rates (excluding rates for Aegeans)
	complusory minimum	possible maximum	
Axis 1	10%	65%	20 - 50% (75% convergence objective)
Axis 2	25%	80%	20 - 55% (80% convergence objective)
Axis 3	10%	65%	20 - 50% (75% convergence objective)

Modulation funds are not used for projects in areas lagging behind in development as defined where GDP is less than 75 percent of the European Union average. These areas are known as 'Objective 1' regions. Also, modulation funds may not be used to fund the Leader+ program, a 'Community Initiative' financed by EU structural funds. Leader+ initiatives are considered the fourth axis. Leader+ initiatives focus on promoting diversification of economic activity in rural areas by applying innovative and integrated strategies between territories and networking. Structural funds are another type of development tool that are not specifically tied to rural programs and have a different budget and distribution from

According to EC Regulation 1782/2003, at least 40 percent of public spending on any rural development project must come from Member State national budget, also known as co-financing. Up to 60 percent of a project's budget can come from Modulated financing.

In total, under the current 5 percent mandatory rate, about 1.2 billion euros a year is shifted from the 34.2 billion euro Direct Aid heading to the 11 billion euro Rural Development section of the 2007 European Union budget. With co-financing by individual Member States the amount States actually receive for Rural Development projects was 13.4 billion euros. Deriving this amount: 1.2 billion euros in Modulation finance multiplied by two to take into account co-financing by Member States plus 11 billion euros of budgeted allocation on Rural Development. This does not include voluntary modulation but is a base value given the mandatory requirement. This does not account for spending by Member States in addition to what they contribute in the form of co-financing.

Conclusion

Modulation gives European Union Member States more flexibility on how to support farmers. Diverting money from the Direct Aid budget chapter to the Rural Development budget chapter allows Member States to contribute national budgetary spending to Rural Development programs in the form of co-finance. It remains to be seen how far this could go but European Union Agriculture Commissioner Mariann Fischer Bowl indicated that compulsory modulation could increase as part of additional Common Agricultural Policy reforms in a speech at the Agra Europe Outlook Forum in March 2007. If the current methodology of financing continues, more of the spending on Rural Development programs will be derived from individual Member States' budgets. Critics have noted that this could represent a re-nationalization of the Common Agricultural Policy if the decoupling trend continues and market-driven supports are reduced and direct payments compensate for the offset.

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Related reports from USEU Brussels:

Report Number	Title	Date Released
E35193	New EU Rural Development Regulation adopted	Oct 6 2005
E34095	Rural Development in the European Union	Dec 8 2004

These reports can be accessed through our website http://useu.usmission.gov/agri or through the FAS website http://www.fas.usda.gov/scriptsw/attacherep/default.asp.

Appendix A

EU CAP Budget Spending by Major CAP Pillar (euros)						
Title	Chapter	Heading	2007	2006	2005
05	02	Intervention in Agricultural Markets	5,615,194,000	8,148,600,000	8,534,209,323
05	03	Direct Aids	36,878,533,000	34,162,745,000	33,586,144,447
05	04	Rural Development	9,657,686,782	11,023,128,789	9,924,119,556

Source: European Union General Budget 2007, Volume 2

Appendix B

Allocation Key Calculation Table Based on Area, Employment, and GDP/capita						
Member State	Area A	Employment B	GDP/capita C	Weighting .65A + .35B	Correction Factor 1 + ((100-C)/3)/100	Allocation Key
Belgium	1.1	1.1	107	1.1	0.98	1.1
Denmark	2.1	1.3	117	1.8	0.94	1.7
Germany	13.5	13.2	105	13.4	0.98	13.0
Greece	2.8	8.9	65	4.9	1.12	5.5
Spain	20.6	14.5	83	18.5	1.06	19.4
France	22.0	15.1	101	19.6	1	19.3
Ireland	3.5	1.7	115	2.9	0.95	2.7
Italy	10.3	15.9	102	12.3	0.99	12.1
Luxembourg	0.1	0.1	196	0.1	0.68	0.1
Netherlands	1.6	4.0	113	2.4	0.96	2.3
Austria	2.7	7.5	112	4.4	0.96	4.1
Portugal	3.0	7.6	70	4.6	1.1	5.1
Finland	1.7	1.9	102	1.8	0.99	1.8
Sweden	2.4	1.6	104	2.1	0.99	2.1
UK	12.5	5.7	102	10.1	0.99	9.9
EU-15 Total	100	100.0	100	100	1	100